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Current Tax Structuring Techniques for Private Equity Funds

While there is a temptation, both on the part of fund managers and fund advisors, to reuse prior forms and structures that have been tested and accepted by investors, all interested parties may find it beneficial to revisit long-standing precedents.

AFSHIN BEYZAEE

The taxation of private equity funds has developed over the last couple of decades in much the same way as a popular sport. Although there have been some minor adjustments to some of the rules around the periphery, the fundamentals remain unchanged. But, that is not to say things have stayed the same. Quite to the contrary, as players become more sophisticated and novel strategies are introduced, the game evolves, creating new opportunities and new challenges.

This article provides an overview of some of the more salient tax issues that arise in the formation of private equity funds in the current market. Since most of the ground rules have changed very little in the recent past, this will entail more of a review of current issues in the field than an analysis of recent changes and developments in the law. The discussion is divided into four parts:

1. Issues arising out of the innovative use of swaps to avoid income that is effectively connected to the conduct of a U.S. trade or business (“ECI”) and unrelated business taxable income (“UBTI”).
2. Implications under the Foreign Investment in Real Property Tax Act (“FIRPTA”) arising out of funds’ investments in business that are not operated in corporate form.

3. Issues associated with the practice of waiving management fees in favor of a special profits interest in the fund.
4. Considerations principals of funds face in making gifts of their shares of the carried interest of the fund.

SWAPS

For the most part, income derived by funds is in the nature of returns on investments in corporate stock, which would not constitute UBTI or ECI. However, as managers have increasingly been able to extract various fees from targets in connection with the fund’s investments, the risk that this unfavorable income might arise has increased.¹ For some time now, funds have been offering alternative structures for investors that are concerned about incurring UBTI and ECI. Typically, these alternatives involve the use of blocker corporations either as feeder entities or as part of a parallel fund structure. Although these structures prevent investors from incurring the bad income, they do interpose an additional tax at the corporate blocker level.²

¹ For an analysis of whether such fees should be UBTI or ECI, see Andrew Needham, “A Guide to Tax Planning for Private Equity Funds and Portfolio Investments” 95 Tax Notes 1215 (May 20, 2002).

² When the fund investment is being terminated, either the fund or the investor, as the case may be, will ordinarily attempt to dispose of the blocker entity rather than the underlying investment to avoid triggering a corporate level of taxation. But, the purchaser will generally demand a discount on the blocker interests to take into account the built-in gain.

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Recently, some investors have begun entering into swaps to avoid the additional level of tax created by the blocker entity.³ In this technique, the investor purchases a total return swap from a financial institution. The investor is promised a return that mirrors the return on a notional investment in the fund. In return, the investor usually puts up some cash as collateral, pays the institution interest at a specified rate on the notional investment (sometimes net of the collateral), and pays a commission or fee to the institution for its services. The swap is intended to qualify as a notional principal contract (“NPC”) under Reg. 1.446-3(c).⁴ As an NPC, the source of the periodic payments from the swap generally would be based on the residence of the recipient, so foreign investors would not be subject to tax on the payments.⁵ Similarly, income from the swap would be excluded from UBTI.⁶

Institutional Hedging. Naturally, the investor expects the institution to hedge this liability with an investment in the fund equal to the notional amount. Few financial institutions are in the business of making unhedged investments. Moreover, the fund is unlikely to divulge the performance information necessary to calculate the swap return in the absence of an actual investment in the fund. So, even as a practical matter, the institutional investor needs to do this in order to obtain the necessary information about the performance of the fund.⁷

However, the institution’s desire to hedge its investment poses a problem for this scheme. In making the fund investment, the institution puts the entire principal amount of its capital commitment at risk. The terms of the swap will, of course, provide that, in the event a failure of this sort occurs, the investor

pays the institution the amount of that loss. But this arrangement puts the institution at risk that the investor will default on its obligation. So the institution insists that the investor to put up collateral—ideally, the full amount of the capital commitment to the fund—to hedge this risk.

Here is the rub. If the investor were to put up the full amount of the capital commitment, there is a risk that the arrangement would be recharacterized by the IRS as the institution making the investment in the fund as an agent for the investor.⁸ Even if the investor were to put up only a portion of the commitment, there is some risk that the investor would be attributed a portion of the fund interest, either directly or through a deemed partnership with the institution.⁹

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Thus, taxpayers are once again faced with establishing that the form of the arrangement reflects its substance. What would be sustained remains to be seen, but advisors are rumored to have been unwilling to bless arrangements in which the investor puts up more than half of the capital committed to the fund as collateral in the swap. If the investor and the financial institution can reach a reasonable balance of their respective risks (i.e., the tax recharacterization risk for the investor versus the risk of default by the investor for the institution), this technique is an attractive way of avoiding ECI or UBTI.

FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT

Historically, few private equity funds have made direct investments in real estate. For investors concerned about being subject to tax under FIRPTA, the managers would include covenants in the fund agreement to avoid investments in U.S. real property interests (“USRPIs”), as defined in Section 897(c). Occasionally, a potential investment would turn out to be a United States real property holding company (“USRPHC”), but this pledge usually would not be much of a constraint for the fund.¹⁰ Furthermore,

³ See Lee A. Sheppard, “Derivatives Used to Beat Tax on Effectively Connected Income,” 113 Tax Notes 621 (Nov. 13, 2006).

⁴ This should not be a difficult hurdle to overcome, but it might be problematic if the institution’s position in the fund becomes too large. The “specified index” for the purposes of the definition would be the return of the fund, which could only qualify thereunder as an index based on objective financial information. Reg. 1.446-3(c)(2)(iii). If the institution gains effective control of the fund, the fund return could be viewed as “within the control” of the institution, thereby disqualifying it as objective financial information. See Reg. 1.446-3(c)(4)(ii).

⁵ Reg. 1.863-7(b)(1). The source might be different where the swap is entered into by a qualified business unit or arises from the conduct of a U.S. trade or business. See Reg. 1.863-7(b)(2) and (3). The fact that the underlying property constitutes a U.S. trade or business should not matter. See TAM 9730007 (May 10, 1997). These payments also would not be subject to withholding. Reg. 1.1441-4(a)(3)(i).

⁶ Reg. 1.512(b)-1(a)(1).

⁷ Presumably, the institutional investor would need a side letter from the fund making an exception from the standard confidentiality provisions allowing it to use information about its investment to calculate the swap return.

⁸ See *National Carbide Corp.*, 336 U.S. 422 (1949), Rev. Rul. 75-31, 1975-1 CB 10, Rev. Rul. 76-26, 1976-1 CB 10.

⁹ See, e.g., *Bentex Oil Corp.*, 20 T.C. 565 (1953), *Marinos*, TCM 1989-492, *Gilreath*, TCM 1989-445.

¹⁰ For example, this might occur where the company’s ownership of real estate is just a byproduct of its primary business, as in the case of a retail company.

because of the hassle associated with the withholding obligation imposed on distributions of USRPI gains to foreign persons, funds were also not keen on falling under FIRPTA.¹¹

Effect of Fuel Prices. The recent surge in fuel prices, however, has led to the formation of a number of funds targeting oil, gas, and alternative fuel source investments.¹² Because of the very generous tax incentives that are

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available for them, these types of enterprises are typically structured as partnerships rather than corporations. As a result, ownership of any USRPIs would be attributed to the foreign investors, thereby subjecting any gains attributable to the disposition of those interests to FIRPTA.¹³ The operating income from these investments would similarly be UBTI or ECI for the fund, but any of the traditional methods for blocking that income would be equally effective here, as would the swap method described above. Unfortunately, the FIRPTA taint is not purged as easily as other forms of ECI.

In cases where the operating company's real property holdings are a minority of the total value of the company, a domestic corporate blocker would prevent the foreign investor from holding a USRPI.¹⁴ However, where the corporation's real property holdings constitute a majority of the value of the company, the corporation would generally be a USRPHC, so its shares would constitute USRPIs.¹⁵ Because most oil, gas, and fuel businesses involve large real property holdings, interposing a corporation between the investor and the operating company will not resolve the problem for these funds.¹⁶

One possible solution would be to house real property intensive businesses under a single corporate holding company together with businesses with mini-

mal real property interests. Done properly, this would have the effect of diluting the real property holdings of the corporate holding company below the threshold for classification as a USRPHC. The drawback to this approach is that it complicates the exit strategy. As discussed above, there is some opportunity to sell a corporate entity that owns a single business at a price that would be above the after tax value of the corporate entity.¹⁷ By placing more than one business under a single corporate umbrella, this opportunity is lost.

Risks of Swaps. Even the swap technique described above has added risks. Aside from the difficulties in organizing the arrangement, there is a potential that the broad definition of USRPI could be read to characterize the swap as a USRPI.¹⁸ Fee estate and leasehold interests are not the only interests that are covered by the definition of USRPI. "The term also includes any direct or indirect right to share in the appreciation in the value, or in the gross or net proceeds or profits generated by, the real property."¹⁹ Because the return on the swap is directly tied to the fund's return on any USRPIs owned by the fund, there is a substantial risk that it could be found to fall within this broad definition.

For now, this problem seems to be limited to a fairly limited universe of funds, but that universe is growing. Funds looking to move into natural resources or other business operated as pass-through entities will likely feel increasing pressure to find a solution to these FIRPTA issues.

MANAGEMENT FEE WAIVERS

A strategy involving management fees raises other issues. Although apparently introduced in the mid 1990s, the "management fee waiver" technique has since grown quite popular with fund managers.²⁰ If the characterization of the arrangement advocated by the managers is upheld, it would allow them to defer income and convert it from ordinary income into capital gain income.

As compensation for managing the assets of the fund, the managers of funds receive a fee. At the same time, the managers are typically expected to invest a portion of their own money in the fund. Increasingly, funds include a provision allowing the managers to

still be avoided by liquidating the corporation's USRPIs in taxable sales before the fund sells or liquidates the corporation, but that would, naturally, trigger a corporate level of tax. Reg. 1.897-2(f)(2).

¹⁷ See n. 2 above.

¹⁸ Section 897; Reg. 1.897-1.

¹⁹ Reg. 1.897-1(d)(2)(i).

²⁰ "Loophole Lets GPs Wave Goodbye to Income Taxes," Private Equity Analyst, p. 24 (November 2006).

¹¹ Section 1445(e)(1), Reg. 1.1445-5(c).

¹² See Rebecca Smith, "The New Math of Alternative Energy," *WSJ*, p. R1 (February 12, 2007).

¹³ Section 1445(e)(1) (withholding on distributions from partnerships of gains from the disposition of a USRPI to a foreign partner); Reg. 1.1445-5(c) (same); Sections 897(g) (withholding on disposition of partnership interest in partnership that owns USRPIs), 1445(e)(5) (same); Reg. 1.1445-11T (same).

¹⁴ Section 897(c)(2).

¹⁵ *Id.*

¹⁶ In the case of oil and gas businesses, for example, the leases or mineral rights would be real property interests. Section 897; Reg. 1.897-1. The FIRPTA consequences to the foreign investors could

“waive” their management fees in favor of a credit against their required capital commitment.

Typically, waiver provisions would work as follows: Assume the fund must pay the managers \$2 million each year as a management fee. The managers could elect to forego the \$2 million management fee and instead receive a profits interest on a hypothetical \$2 million investment in the fund. This hypothetical investment would also be credited against the managers’ required capital commitment. Limited partners are still required to contribute \$2 million to the fund, just as they would have had to if the management fee had not been waived, but they are entitled to a recovery of that amount.

The distribution scheme on this hypothetical investment is unique. Initially, it is viewed as a limited partnership interest. Accordingly, it bears distributions under the standard distribution waterfall. But, unlike a regular limited partnership interest, the limited partners who “paid” the waived management fee only receive the return of capital distribution (in the example, \$2 million).²¹ All of the profits distributions go instead to the managers. In addition, the managers are granted a special preference in the fund’s profits. After all of the limited partners have recovered their capital (including the contributions in respect of the waived fees), the initial profits of the fund are distributed to the managers until they are made “whole” for the management fees they waived (in the example, the first \$2 million of the funds profits). Only after the managers have received this preference are the profits distributed according to the traditional waterfall.

If this were respected, the managers would be allocated their share of the fund profits, which would typically be capital gain, instead of receiving management fees, which would be ordinary income. Furthermore, the managers would only recognize that income when they are allocated income of the fund, not up front when the management fee would otherwise be paid. But, there are a number of obstacles on the way to that result.

Constructive Receipt? At the outset, there is what appears to be a basic constructive receipt issue. Can the managers avoid having income from the management fees by waiving them? If the managers have already earned the fees and have a right to them, it is a basic rule of taxation that they cannot turn their back on the fees and avoid the income.²² This risk is

²¹ Note that even in a typically waterfall distribution, the portion of a limited partner’s contribution that is used to pay management fees is distributed out to the limited partner as part of the “capital recovery” step of the waterfall.

²² Reg. 1.451-1, 1.451-2; Hamilton Nat. Bank of Chattanooga, 29 BTA 63, 67 (1933) (“A taxpayer may not deliberately turn his back upon income and thus select the year for which he will report it.”).

minimized in most funds by requiring the managers to waive the fees before the period to which they relate.²³ Because the managers have no right to the payment of the fees prior to their performance of management services, they cannot be said to have constructively received the fees at the time of that waiver. Instead, the managers should be taxed based on the revised arrangement (i.e., on an as-waived basis).²⁴

Waiver Interest. The managers do not simply give up the fees for nothing. They receive a new profits interest (a “Waiver Interest”) and their capital commit-

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ment is partially (or fully) satisfied. The managers’ Waiver Interest would presumably fall within the safe harbor described in Rev. Proc. 93-27,²⁵ so the managers should have no income at the time of the waiver. In effect this is the equivalent of a renegotiation of the managers’ compensation prior to it being earned.²⁶ It would be the same as a non-partner officer of a partnership agreeing in advance to forego a cash salary in exchange for a profits interest. Clearly, under Rev. Proc. 93-27, the receipt of this interest would not be taxable even though the salary would have been. Moreover, any capital gain income flowing up to the officer would retain its character, even though the salary would have been ordinary income.

This entire construct is shaken, however, in many cases when the fund is structured such that the entity managing the fund is different from the entity that commits the managers’ capital. So as to limit and segregate the various liabilities that could arise, the management function is often performed by one entity, while the general partner function is performed by a second entity, and one or more additional entities commit the capital required of the managers as affiliated limited partners. In this situation, the waiver by the management company does not result in the management company receiving the Waiver Interest. Because it is the affiliated limited partners

²³ In most funds, the management fees are paid semiannually or quarterly in arrears. Some funds will require the waiver prior to the quarter or semiannual period for which the fees accrue. The more conservative funds require the waiver to be made before the taxable year in which they accrue or fix the waiver for the entire life of the fund in the partnership agreement.

²⁴ See Rev. Rul. 58-162, 1958-1 CB 234.

²⁵ 1993-2 CB 343.

²⁶ *Id.*

that have the capital commitments, it is they whose commitments are reduced in exchange for the Waiver Interest.

This raises the specter of assignment of income. In the basic situation described above, this was not an issue because the managers were not giving another party the right to the income. Rather, they were changing the nature of what they were receiving. Here, in contrast, the management company is foregoing fees and different entities are receiving the Waiver Interests.

Even so, this does not fall neatly within the traditional assignment of income construct, which is to treat the assignor as having received the income and then having transferred that income to the assignee. In this case, the affiliated limited partners do not receive what the management company would have received—they receive property that is entirely different. Thus, there is a threshold problem of determining what is being “assigned.” Is the management company assigning its right to the fees to the limited partners, who, in turn, use those fees to acquire the Waiver Interests? Or, is the management company treated as being granted the Waiver Interest for its services and assigning that interest to the affiliated partners? As discussed above, as long as the management company makes the election before it has earned or received its compensation, it should be allowed to elect whatever form of compensation it desires. It would seem to follow, then, that if the management company could choose the form of its compensation, the “income” being assigned should be the Waiver Interest.

In a traditional application of the assignment of income doctrine, after the assignor is treated as having received the relevant income, the assignor is deemed to have transferred the income to the assignee. This deemed transfer is clearly not a sale or exchange, as the management company is not receiving anything in exchange from the affiliated limited partners. Because this is a commercial setting, it is unlikely that the transfer of the profits interest could be viewed as a gift.²⁷ Similarly, because it is in the course of a profit-making enterprise, it seems unlikely that it could be viewed as some kind of windfall income of the affiliated limited partners.

If the management company and the affiliated limited partners are under common control, the most probable treatment would be a deemed distribution of the Waiver Interest by the management company followed by a deemed contribution to the affiliated

²⁷ See Reg. 25.2512-8, Rev. Rul. 68-558, 1968-2 CB 415. If one of the affiliated limited partners were a charity, there is a potential that it could be viewed as a charitable contribution.

limited partners. These deemed transfers probably would not be taxable events.²⁸ Unfortunately, because the deemed transfer would occur within two years of the deemed initial grant, the grant of the profits interest would not fall squarely within the four corners of Rev. Proc. 93-27. So, whether its receipt would be a taxable event (and the amount of income on such event) for the management company would be based on the uncertain case law addressing the issue.²⁹

If the same interests do not own both the management company and the affiliated limited partners, the analysis becomes even more complex. In all probability, the appropriate characterization would depend on the relationship among the owners of the management company and the affiliated limited partners. Since their varying interests are likely the result of an outside agreement, the terms of that agreement would likely guide the analysis.

Although there may be more support for some of these propositions than this cursory analysis reflects, it is clear that obtaining the desired results requires a careful parsing of a number of different rules.

GIFTS OF INTERESTS IN THE GENERAL PARTNER ENTITY

Typically, the general partner of the fund is structured as a limited liability company owned by the individual managers of the fund, and each manager is granted a share of the amounts the general partner receives pursuant to its carried interest. Because the carried interest of the general partner can become very valuable in a successful fund, many managers have realized that advance planning can help them avoid substantial gift or estate taxes. In this regard, managers are increasingly being advised to give away their interests in their shares of the carried interest at the time the fund is formed.³⁰

Just as the general partner's carried interest is a profits interest in the fund, the managers' shares of the carried interest are profits interests in the general partner. Consequently, the managers' receipt of their interests would ordinarily qualify for the

²⁸ Sections 721, 731.

²⁹ See *Diamond*, 492 F.2d 286 (7th Cir. 1974), *St. John v. U.S.*, (D. Ill. 1983), *Kenroy Inc.*, TCM 1984-232, *Campbell*, 943 F.2d 815 (8th Cir. 1991), reversing TCM 1990-162. Along these same lines, query whether the receipt of the carried interest by the general partner would be a taxable event where it is not providing the management services.

³⁰ Gift tax is only imposed on the value of the interest at the time of the gift—if the transfer is done properly, any subsequent appreciation is not subject to additional gift tax or estate tax on the donor's death. See Section 2512 (done properly). But see Sections 2035 – 2038 (consequences if not done properly).

safe harbor treatment in Rev. Proc. 93-27.³¹ The challenge in implementing this estate planning technique is that the safe harbor purports to not apply if the profits interest is “transferred” within two years of grant.

Defective Trusts. One customary means of making a gift is to put a particular asset in a “defective trust.”³² The terms of the trust are such that when the asset is put into the trust, the donor has relinquished sufficient control over the asset that it is considered a completed gift for gift and estate tax purposes.³³ But, the donor retains one or more powers (typically a power of appointment) that cause the trust to be a grantor trust. This allows the donor to bear the tax on any income or gain generated by the asset without having the payment of such taxes constituting additional gifts.³⁴

It was probably given little thought when the defective trust scheme was first hatched, but there is a rather curious characteristic of grantor trusts that is exceptionally helpful for the managers: when a person contributes assets to a grantor trust with respect to which he is a grantor, the IRS does not consider there to have been a “transfer” for tax purposes.³⁵ As a result, when a manager puts his profits interest into the defective trust, it appears that he does not violate the requirement that the interest not be “transferred” within two years as he might if he had made a direct gift of the interest.

Transfer and Gift Issues. Even though the tax-free status of the manager’s receipt of the interest is preserved, it appears that the contribution would trigger the gift tax. The contribution of an asset to a defective trust, as was indicated above, is ordinarily a completed gift

for gift and estate tax purposes.³⁶ There appears to be no reason why the result should be any different where the asset is a profits interest. While Rev. Proc. 93-27 says that the receipt of the interest by the service provider is not a taxable event, it says nothing about a gift of that interest to another.³⁷ So, presumably, the contribution of the interest to the defective trust would be a taxable transfer for gift tax purposes. The

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question, then, becomes: What is the tax treatment of that gift?

Generally, the value of an asset is the same for gift tax purposes as for income tax purposes.³⁸ But, without going into gory detail, suffice it to say that the state of the law regarding the proper method for valuing profits interests in partnerships for tax purposes is unsettled.³⁹ To avoid getting bogged down by this morass, some practitioners have sought to side-step the issue by advising their clients to have the interest issued directly to the defective trust.

As indicated above, the IRS does not view a contribution of assets to a grantor trust as a “transfer” for income tax purposes.⁴⁰ The stated premise on which this conclusion is based is the fact that the grantor is treated as the actual owner of the trust assets for income tax purposes.⁴¹ Thus, when the trust receives the profits interest, for income tax purposes, it is as though the grantor received the interest. Just as a contribution of the interest to the trust should not affect the qualification for the safe harbor under Rev. Proc.

³¹ This should be true even if the general partner’s receipt of its carried interest from the fund would not qualify for the safe harbor because it is not found to have provided any services to the fund. See n. 16 above. That the underlying profits stream might not qualify should not alter the fact that the principals’ receipt of profits interests satisfy the requirement that the interest be received for services performed for the partnership.

³² These trusts are also often referred to as “defective grantor trusts” or “intentionally defective grantor trusts.” When the grantor trust rules were originally adopted, it was generally considered undesirable to form trusts covered by the rules. The fact that the trust was a grantor trust made it “defective.”

³³ See Rev. Rul. 2004-64, 2004-2 CB 7.

³⁴ Rev. Rul. 57-315, 1957-2 CB 257; Rev. Rul. 2004-64.

³⁵ The IRS takes the position that the “owner” of a grantor trust “is considered to be the owner of the trust assets for federal income tax purposes.” Rev. Rul. 85-13, 1985-1 CB 184. However, the Second Circuit has held, to the contrary, that a grantor trust is an entity separate from the grantor. *Rothstein v. U.S.*, 735 F.2d 704 (1984), nonacq. Rev. Rul. 85-13.

³⁶ See Rev. Rul. 2004-64.

³⁷ If the profits interest were substantially unvested, the gift arguably would not be completed until the interest vests. Compare Rev. Rul. 98-21, 1998-1 CB 975 (where a taxpayer makes a gift of a unvested nonstatutory stock options, the gift is not complete until the options vest because until they vest, “the rights that [the donor] possesses in the stock option[s] have not acquired the character of enforceable property rights susceptible of transfer for federal gift tax purposes.”) with Rev. Proc. 2001-43, 2001-2 CB 191 (“a service provider will be treated as receiving the [unvested profits] interest on the date of grant,” provided certain conditions are met).

³⁸ *Janis*, 469 F.3d 256 (2d Cir. 2006).

³⁹ For some of the gory details, see McKee, Nelson, Whitmire, *Federal Taxation of Partnerships and Partners*, 3d ed., ¶ 5.02.

⁴⁰ Rev. Rul. 85-13.

⁴¹ *Id.* See n. 35 above.

93-27, a receipt of the interest by the trust instead of the principal should not affect it either.

Here, the rubber hits the road. Because the interest is received directly by the trust, there is no event after the manager's "receipt" of the interest that effects a transfer of the interest from the manager to the donee for gift tax purposes.⁴² Indeed, for transfer tax purposes, there does not appear to be any moment where the interest is in the manager's estate. Before the interest is issued, he has no interest in any asset that could be included in his estate, and from the moment it is issued, the interest is, by design of the trust, outside of his estate. In order for there to be a valid gift, the donor must generally have an interest that is transferred.⁴³ So, since the donor never has an interest before the receipt of the profits interest by the trust, where does the gift occur?

It would be difficult to say that the general partner entity is making a gift of the interest because the entity is receiving the services of the manager in exchange for granting the interest.⁴⁴ Similarly, it would be difficult to say that it was a gift by the other members of the entity.

Also of dubious merit is an argument that the manager had transferred a right to receive the interest to the trust.⁴⁵ Whatever may be said of the intentions of the relevant parties prior to the grant of the interest, the beneficiary of the trust would have no enforceable right to compel the issuance of the interest to the trust. If the manager decided to have the interest transferred directly to himself instead of the trust, the beneficiary would have no recourse. And, it is well established that a mere promise to make a gift is not a taxable transfer.⁴⁶

What appears to be the most promising argument for the government is that the act of having the interest issued to the trust was the gift. The regulations broadly state:

The gift tax also applies to gifts indirectly made. Thus, any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax.⁴⁷

⁴² See Section 2501(a).

⁴³ See Davenport, 184 F.3d 1176 (10th Cir. 1999).

⁴⁴ See Reg. 25.2512-8, Rev. Rul. 68-558.

⁴⁵ Naturally, if the manager had actually given the trust such a right, the conclusion would be different. This discussion assumes that the principal was advised well enough to avoid such an error.

⁴⁶ Bradford, 34 TC 1059 (1960), acq. 1961-2 CB 4. See also, Rev. Rul. 69-347, 1969-1 CB 227 (a promise to make a gift becomes taxable when it becomes enforceable under state law).

⁴⁷ Reg. 25.2511-1(c)(1).

Clearly, an interest in the profits interest is conferred upon the beneficiary of the trust. But, as noted above, it is not clear that the manager had any interest with which to part at the time of the issuance of the interest.⁴⁸ Just as the beneficiary has no right to compel the issuance of the interest to the trust prior to the grant of the interest, the manager has no interest or right to an interest in the entity until it is actually granted.⁴⁹ Since the manager must have an interest to transfer in order for there to be a gift for gift tax purposes, there would appear to be no basis for imposing a gift tax where the manager never has anything to transfer.⁵⁰

The list of challenges the IRS could raise goes on, but is not clear that any are free from difficulty. That said, it is likely that these issues are most likely to reach a court only in cases in which the carried interests become very valuable. In those circumstances, there is a substantial risk that a court might be offended enough by the result that it would use any justification to find a taxable gift. Accordingly, taxpayers going down this path would be well advised to implement the strategy carefully to avoid any missteps that a court could exploit in imposing a gift tax.

CONCLUSION

As the trends discussed above indicate, there continue to be interesting and challenging issues in the world of private equity despite (or, perhaps, as a result of) a fairly stable set of rules. Accordingly, while there is a temptation, both on the part of fund managers and fund advisors, to reuse prior forms and structures that have been tested and accepted by investors, all interested parties may find it beneficial to revisit long-standing precedents. ■

⁴⁸ See Davenport, 184 F.3d at 1183 ("While this requirement implies that the donor must have some dominion and control with which to part, neither the tax code nor the federal tax regulations shed further light on the type of ownership interest necessary to effect a taxable inter vivos gift.").

⁴⁹ If the principal did have such a right prior to the issuance of the interest, it is possible that he would be already considered a "partner" in the entity for tax purposes. See Kenfield, 783 F.2d 966 (10th Cir. 1986), Yonadi, 21 F.3d 1292 (3d Cir. 1994).

⁵⁰ See Davenport, 184 F.3d 1176. The IRS could fabricate an additional step in which the principal receives the profits interest before contributing it to the trust. But, the courts generally frown upon recharacterizations that add steps. See Esmark, Inc., 90 T.C. 171, 196-97 (1988), aff'd by court order 886 F.2d 1318 (7th Cir. 1989) ("Useful as the step transaction doctrine may be in the interpretation of equivocal contracts and ambiguous events, it cannot generate events which never took place just so an additional tax liability might be asserted."), citing Grove, 490 F.2d 241 (2d Cir. 1973), in turn citing Sheppard v. U.S., 361 F.2d 972 (Ct. Cl. 1966).